

2009 MONETARY POLICY STATEMENT - MID-TERM REVIEW

1. Introduction

- 1.1 *The Mid-Term Review (MTR) of the 2009 Monetary Policy Statement (MPS) evaluates progress in achieving the 3 – 6 percent inflation objective; it also assesses the medium-term financial and economic conditions and other factors that are likely to influence the inflation outlook and policy formulation in the remainder of the year. Overall, the assessment informs stakeholders of the key economic developments, and consequently the appropriate monetary policy stance, with a view to fostering public expectations of low, sustainable and predictable inflation.*
- 1.2 *The medium-term inflation objective of 3 – 6 percent represents the Bank’s view of price stability and is considered to be consistent with sustainable long-run growth of the economy. In addition to promoting growth, low inflation that is close to that prevailing in the country’s trading partners contributes to attaining stability of the real effective exchange rate (REER).*
- 1.3 *As projected at the beginning of the year, inflation fell in the first half of 2009, in the context of weaker output growth and lower fuel prices, and decreased from 13.7 percent in December 2008 to 7 percent in June 2009.¹ Given the outlook for benign price pressures over the medium-term and the risk of a decline in output expansion emanating from the deterioration in global economic performance, the Bank reduced the Bank Rate by a cumulative 400 basis points in the same period (December 2008 – June 2009). Looking ahead, inflation is expected to fall within the objective range in the short-term and, subject to the balance between the assessment of expected downward trajectory and the upside risks, it allows scope for monetary policy to remain supportive of the envisaged recovery of GDP.*
- 1.4 *While world economic performance continues to be weak, with GDP growth for 2009 projected at -1.4 percent (3.1 percent in 2008), the monetary and fiscal stimuli as well as liquidity and financial support to banks and industry across the world appear to underpin the imminent global economic recovery. The world economy is, therefore, forecast to expand by a faster (albeit low) rate of 2.5 percent in 2010. The improved performance, however, still largely depends on the resumption of normal financial intermediation under enhanced supervisory standards, continuation of open and free international trade and support for vulnerable economies.*

¹ Inflation fell further, to 6 percent, in July 2009.

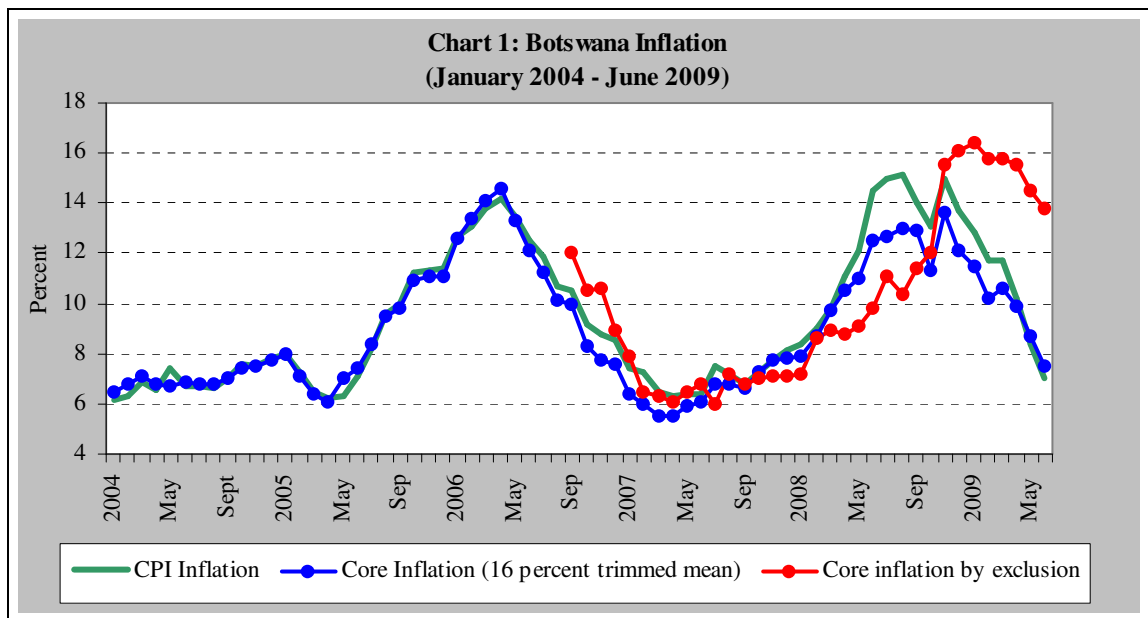
2. Monetary Policy Framework

- 2.1 *The monetary policy objective is anchored on the attainment of price stability, as defined by the medium-term objective range of 3 – 6 percent. A low and predictable level of inflation contributes to the broader national objectives of sustainable growth and development through promoting savings mobilisation, fostering productive investment and facilitating international competitiveness of the domestic industry.*
- 2.2 *The Bank's policy framework entails a forecast-based and forward-looking monetary policy strategy with a medium-term focus. The medium term is defined as a three-year rolling period, which is considered a reasonable time frame over which monetary policy can affect price developments. The policy is guided by the medium-term forecast for inflation, as derived from an assessment of prospective developments for various determinants of inflation. Among the influences on inflation are demand conditions, changes in administered prices and consumption taxes, as well as public expectations with respect to the rate of price changes. The Bank uses interest rates and open market operations to influence demand and, ultimately, price developments in the desired direction. However, the policy response to inflationary pressures is premised on an assessment of the sources of inflation. In particular, there is a distinction between factors with a transitory impact, associated with changes in administered prices and consumption taxes, and those likely to have a lasting influence on inflation, such as changes in demand conditions. Meanwhile, the alternative measures of inflation, including headline, the 16 percent trimmed mean and inflation excluding administered prices, are indicative of the sources of inflation and serve to explain price developments.*
- 2.3 *Operationally, the policy framework encompasses regular meetings of the Monetary Policy Committee, which reviews inflation forecasts and the monetary policy stance to take account of ongoing changes in economic circumstances that affect the outlook for the determinants of inflation. Therefore, the Bank is able to respond in a timely manner to prospective developments that would lead to a significant (and lasting) deviation of inflation from the objective range. High and volatile inflation is detrimental to economic growth as it discourages financial saving and generates uncertainty for investment decisions; and it quickly erodes the purchasing power of incomes, hence reducing living standards. On the other hand, sustained periods of low or rapidly falling inflation could be indicative of a decline in economic performance, which could require monetary policy easing to stimulate growth.*
- 2.4 *Achieving the Bank's inflation objective also contributes to stabilisation of the real effective exchange rate (REER), which helps to promote international competitiveness of domestic industries. In the context of the crawling band exchange rate arrangement, and in the event the inflation objective remains higher than inflation in trading partner countries, the Bank implements a continuous adjustment of the nominal effective exchange rate to maintain stability of the REER.*
- 2.5 *An integral part of formulating and implementing monetary policy is communicating the Bank's framework to stakeholders, as well as apprising the public on economic developments, inflation outlook and the factors considered in determining the monetary policy stance. Such communication is done through, among others, the Annual Reports, Monetary Policy Statements (and mid-term reviews), economic briefings and press*

releases following Monetary Policy Committee meetings. In addition to the duty of accountability, transparency enhances public understanding of the policy framework, which promotes policy credibility and the degree to which the Bank could succeed in influencing inflation expectations and maintaining price stability.

3. Inflation in the first half of 2009

3.1 Inflation maintained a downward trend in the first half of 2009, largely reflecting the impact of changes in fuel prices. In addition to the decrease in fuel prices, the effect of the large fuel price increases in the first half of 2008 dropped out of the inflation calculation. Overall, inflation declined from 13.7 percent in December 2008 to 7 percent in June 2009, but was above the upper end of the Bank's medium-term inflation objective range of 3 – 6 percent.² Both measures of core inflation (16 percent trimmed mean and core inflation excluding administered prices) also decreased from 12.1 percent to 7.5 percent and from 16.1 percent to 13.8 percent, respectively. The higher level for the latter is due to the absence of the impact of the fuel price decrease in this measure.

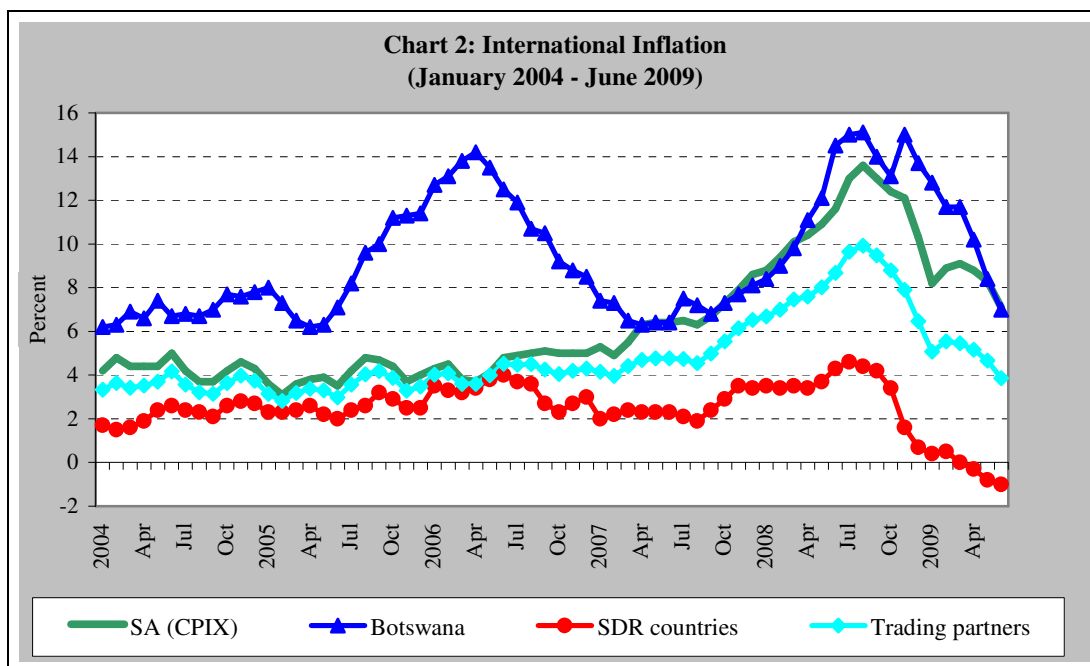


3.2 Average inflation for the trading partner countries also trended downwards, falling from 6.5 percent in December 2008 to 3.9 percent in June 2009, against the background of weak global economic performance and the substantial decline in international commodity and oil prices in the second half of 2008. In South Africa, headline inflation³, which is now the target measure for the South African Reserve Bank (SARB), eased from 9.5 percent in December 2008 to 6.9 percent in June 2009, due to lower rates of increase

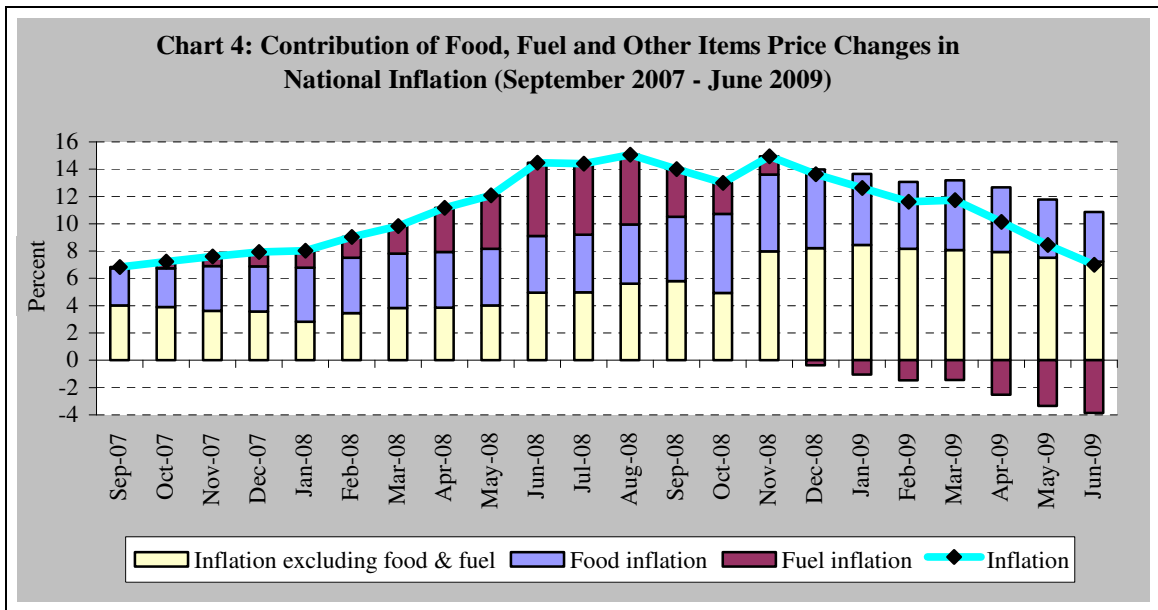
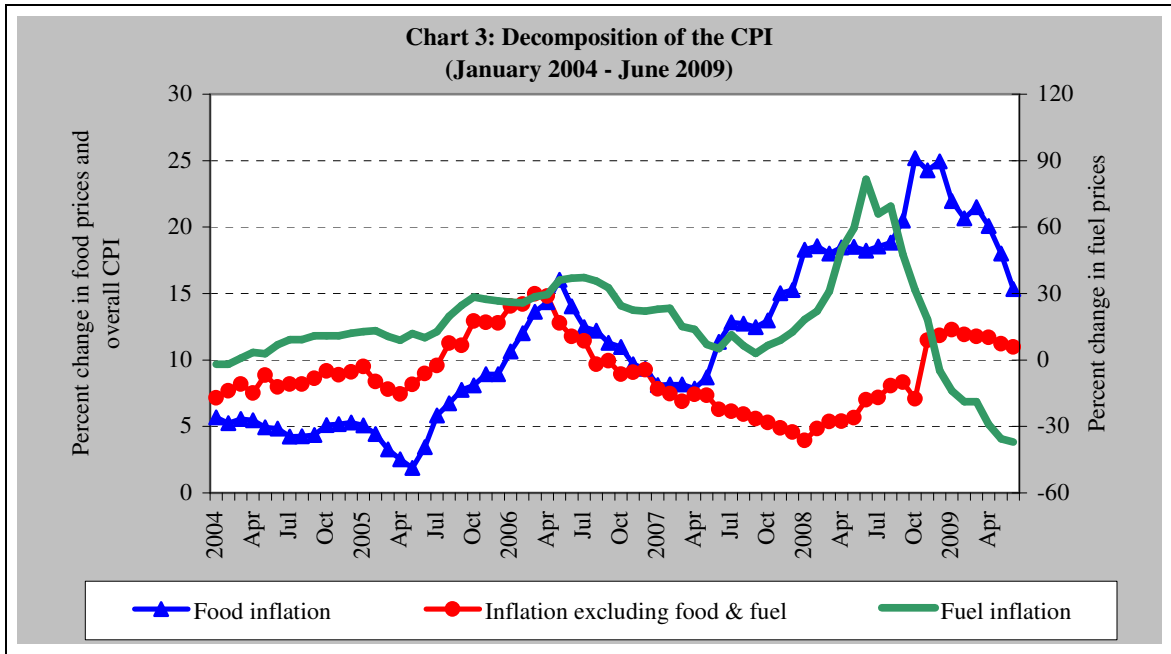
² Inflation fell to 6 percent in July and, therefore, is equal to the upper end of the objective range.

³ The SARB replaced the CPIX with the headline inflation as the target measure of inflation at the beginning of the year and also revised the CPIX. Headline inflation is compiled from all the primary and secondary urban areas in which CPI data are collected. The revised CPIX excludes owner's rent which is based on rentals paid for similar residential houses as those found in the owner-occupier market, while the old CPIX excluded interest rates on mortgage bonds from the headline inflation.

for energy and food prices. Nevertheless, South African inflation was above the target range of 3 – 6 percent in the first half of 2009. For the SDR countries, which include economies that were in recession in the first half of the year, inflation decelerated from 0.7 percent to -0.8 percent.



3.3 On the domestic front, the previous year's upward influence of fuel and food price increases on inflation was substantially reduced in 2009 (Chart 3). Notably, the annual change in the cost of fuel decelerated from -4.9 percent in December 2008 to -37 percent in June 2009, due to the combination of price reduction in the second half of 2008 and the impact of last year's large increase dropping out of the inflation calculation. Meanwhile, the year-on-year increase in food prices decreased from 24.9 percent in December 2008 to 15.3 percent in the same period.



3.4 *Imported tradeables inflation fell significantly from 11.9 percent in December 2008 to 0.4 percent in June 2009, thus reflecting the impact of the decrease in the cost of fuel, as well as lower food price increases. Domestic tradeables inflation also decreased from 26.4 percent in December 2008 to 18 percent in June 2009. The higher level of domestic tradeables inflation reflects the impact of the 30 percent additional tax on alcoholic beverages that was introduced in November 2008. Overall, all tradeables inflation eased significantly from 16.3 percent to 6.5 percent over the same period. Meanwhile, non-tradeables inflation rose from 6.4 percent in December 2008 to 9.8 percent in January 2009, before decelerating to 8 percent in June 2009 as the previous year's increase in electricity tariffs and transport fares dropped out of the inflation calculation.*

- 3.5 *Demand pressures on inflation were generally low in the context of the deteriorating world economy that had an adverse impact on domestic economic activity, particularly mining output. In the first quarter of 2009, diamond production was 68.6 percent lower than output for the same period last year and, as a result, the first quarter GDP contracted by 20.3 percent. In contrast, the robust performance of the non-mining sector was maintained, with annualised first quarter growth of 9.3 percent and strong performance of agriculture (14.1 percent), finance and business services (16 percent), and construction and social personal services, which both expanded by 12.9 percent.*
- 3.6 *While there was virtually no contagion from the global financial crisis to the domestic banking system⁴, the private sector credit growth was 4.3 percent in the first six months of 2009, and much slower than the 9.4 percent for the corresponding period in 2008. Indeed, lending to private businesses fell by 4.1 percent (compared to 15.2 percent growth in 2008) while household borrowing increased by 10.6 percent (compared to 5.5 percent in 2008). Credit expansion in the twelve month period to June 2009 was 22.3 percent, lower than the 27 percent for the year to June 2008. Although credit expansion continues to support output expansion, there is evidence of a slowdown in monetary growth and this is reflecting a more cautious lending environment, reduced demand for bank financing associated with slow economic activity, and an increase in loan loss provisions. The upward income effect on household borrowing during this period was limited by the absence of an across-the-board wage increase for civil servants in 2009, which would normally be replicated by other employers.*
- 3.7 *The government expenditure programme for 2009/10 was subject to review in the light of lower revenue, and thus potentially reducing the impact of public spending on economic activity and contributing to the lacklustre GDP expansion. Nevertheless, recurrent and development expenditures in the fiscal year to March 2009 were robust and 41.2 percent higher than spending for the corresponding period in 2008; this compares with the original budget estimate of a 14.7 percent increase in expenditure.⁵ For the fiscal year 2009/10, the deficit of P13.4 billion announced in the February 2009 Budget Speech, and representing annual expenditure growth of 5.3 percent, is likely to be significantly reduced in the context of the 5 – 7 percent cut in budgeted expenditure and the ongoing review and prioritisation of projects. However, the Government still maintained a countercyclical stance and has secured an external loan to finance the deficit,⁶ while domestic bond proceeds continue to be earmarked for the development of tertiary education infrastructure.*

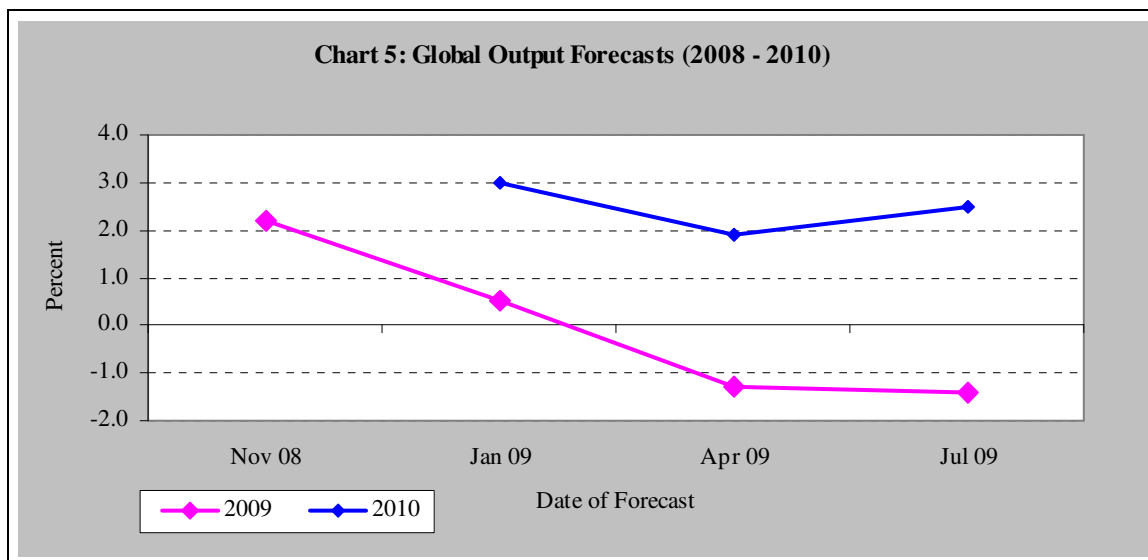
⁴ *The first round effect of the global financial crisis on the domestic banking system has been limited due to a low level of foreign exposure and the absence of risky derivatives in their operations. However, there could be a second round impact on the asset quality and profitability of banks emanating from the effect of weak domestic economic activity and income losses.*

⁵ *The growth in government spending by 41.2 percent compared to the budgeted 14.7 percent was due to supplementary expenditure authorised by Parliament in December 2008.*

⁶ *The Government has negotiated a loan of USD1.5 billion (approximately P10.5 billion) from the African Development Bank to help finance the deficit.*

4. Monetary Policy Implementation in the first half of 2009

4.1 The projections for both inflation and output were largely unchanged from the prognosis made at the beginning of the year. Nevertheless, there were signs in the first half of the year of a quicker global economic recovery than earlier anticipated, which would also imply a shorter period of output contraction in Botswana (Chart 8). There was also a risk of inflation being higher and a delayed return to the medium-term objective range than earlier projected, especially taking account of price developments in South Africa and recovery in international oil prices.⁷



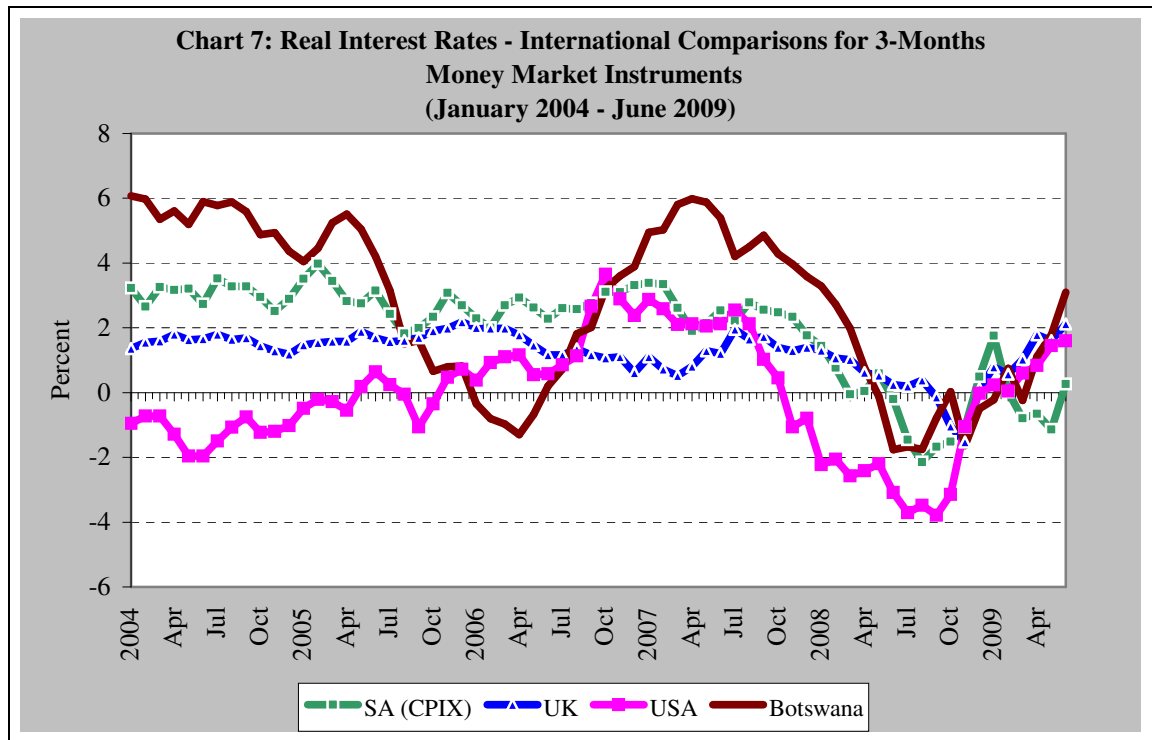
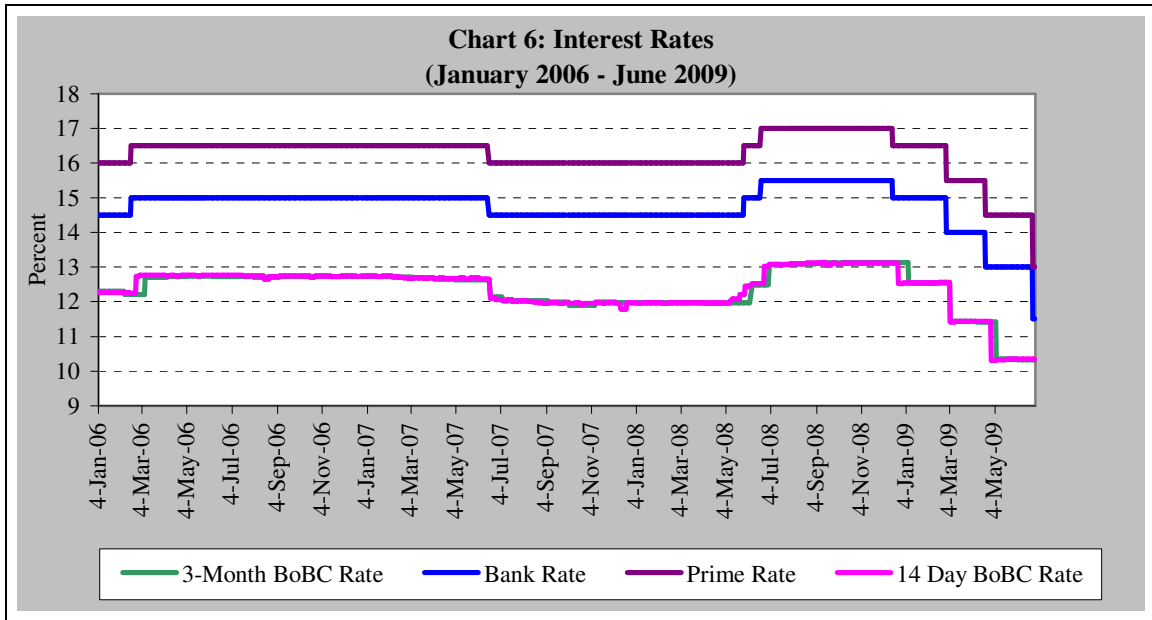
Source: World Economic Outlook, International Monetary Fund.

4.2 Overall, with the decline in the rate of price changes expected to continue and inflation expected to fall towards the medium-term objective range of 3-6 percent, monetary policy was eased in the first half of 2009, thus providing stimulus to economic activity in the face of downside growth risks associated with the intensification of the impact of the global economic deterioration. The Bank Rate was reduced by 100 basis points each time in February and April 2009 and by 150 basis points in June 2009 to 11.5 percent. In response, money market interest rates fell (Chart 6). The average prime lending rate of commercial banks decreased from 16.5 percent at the end of December 2008 to 13 percent in June 2009, while the 91-day deposit rate fell from 8.53 percent in December 2008 to 7.64 percent in June 2009.⁸ The yield on the 14-day BoBC decreased from 12.55

⁷ It is noted, however, that the forecast for South African inflation includes the impact of the 31.3 percent increase in electricity tariffs by Eskom, which would have no immediate direct effect on prices in Botswana (to the extent that the Botswana Power Corporation does not replicate the Eskom tariff increase).

⁸ In March 2009, the Bank directed commercial banks to maintain an anchor 91-day deposit facility paying Bank Rate minus 4 percent. This was done partly to influence symmetric changes for both deposit and lending interest rates in response to Bank Rate adjustments, with a view to ensuring a more efficient policy transmission process, and in order for policy adjustments to have the desired effect in influencing saving and borrowing decisions.

percent at the end of December 2008 to 8.66 percent in June 2009, while the 3-month BoBC yield fell from 13.13 percent to 8.71 percent⁹.



4.3 Given the faster decrease in inflation, real interest rates rose (Chart 7). The real interest rate for the 14-day BoBC increased from -1.01 percent in December 2008 to 1.55 in June

⁹ The 8.71 percent for the 3-month BoBC was recorded at the July 2009 auction, which is the earliest auction date for this instrument following the June 2009 reduction in the Bank Rate.

2009, and for the 3-month BoBC the real rate rose from -0.5 percent to 1.6 percent in the same period (see footnote 7). Similarly, the real prime lending rate rose from 2.46 percent in December 2008 to 5.61 percent in June 2009, while the real 91-day deposit rate increased from -4.55 percent to 0.6 percent.

- 4.4 As domestic inflation remained higher than the average inflation of trading partner countries, the nominal exchange rate of the Pula crawled downwards. Therefore, the nominal effective exchange rate (NEER) depreciated by 1.3 percent in the six month period to June 2009. The Pula appreciated by 9.9 percent against the SDR, mostly reflecting the 10.7 percent strengthening against the US dollar. With imminent prospects for global economic recovery, the US dollar (which previously benefited from the flight to quality (safe haven) phenomenon), weakened as investors shifted to higher yielding emerging market portfolios. In turn, the Pula depreciated by 8.1 percent against the rand, which benefited from the same shift in portfolio holdings. The real effective exchange rate (REER)¹⁰ of the Pula depreciated by 0.6 percent in the six months to June 2009 due to both the narrowing of inflation differentials with trading partner countries and the nominal depreciation against the rand. In effect, the rate of crawl more than offset the inflation differential, thus reversing part of last year's appreciation of the REER.
- 4.5 Movements in interest rates and the Pula exchange rate are reflected in changes in the real monetary conditions index, which measures the relative tightness and easiness of financing conditions in the economy. As shown in Chart 10, with the progressive reduction in interest rates, the fall in inflation and narrowing of inflation differentials vis-à-vis the average inflation of trading partner countries, real monetary conditions loosened, potentially facilitating domestic demand-led stimulus to economic activity, as well as enhanced international competitiveness of the domestic industry.

5. **Medium Term Inflation Outlook**

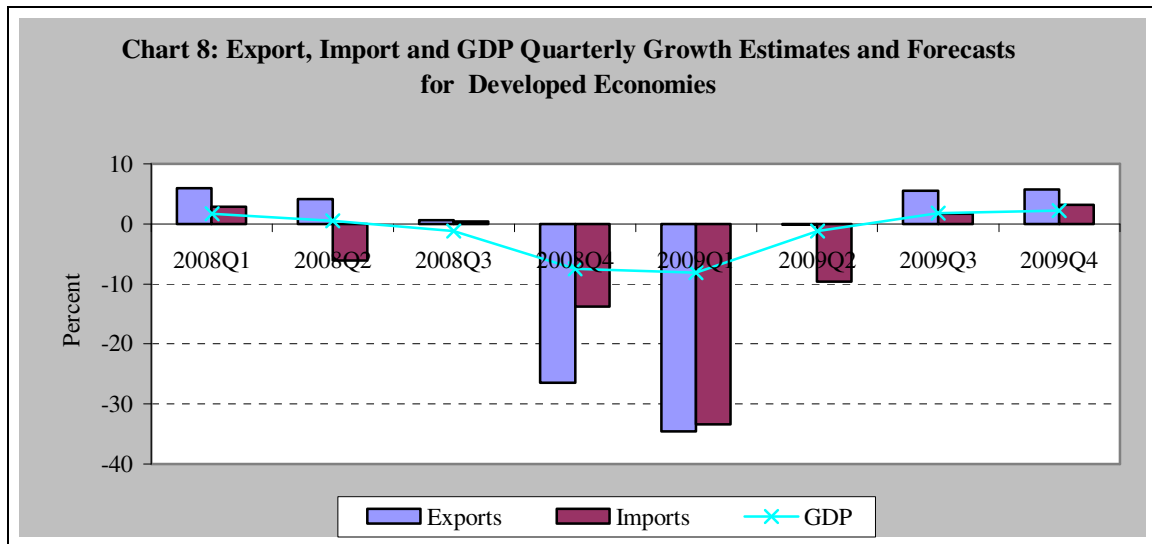
- 5.1 The forecast inflation path is determined by a combination of, among others, prospective developments with respect to demand-pull pressures resulting from real economic activity, imported inflation and other exogenous factors, such as changes in administered prices. The external influences on domestic prices include economic and financial developments in South Africa, which is Botswana's major trading partner, as well as global events, such as changes in international commodity prices and demand in major markets.¹¹
- 5.2 South Africa's GDP growth is projected to decelerate from 3.3 percent in 2008 to 1.1 percent in 2009, mainly reflecting the decline in manufacturing and mining output, as well as sluggish domestic demand conditions. Despite the forecast output contraction and the associated downward pressures on inflation, there are upside risks to the inflation outlook emanating from a 31.3 percent increase in ESKOM electricity tariffs. Overall, South Africa's annual headline inflation is projected to remain above the upper end of the 3 - 6 percent inflation target for the whole of 2009. In the context of sluggish

¹⁰ The REER is calculated using the weighted average inflation for the SDR countries and South African CPIX inflation.

¹¹ Forecasts for external variables are obtained mainly from the Reuters survey of forecasters.

economic activity, the South African Reserve Bank is expected to maintain the current easy monetary policy stance, but with a reduced likelihood of further interest rate cuts in the short term.

- 5.3 World economic performance remains weak, with output forecast to decline by 1.4 percent in 2009, from an estimated growth of 3.1 percent the previous year, before recovering to 2.5 percent in 2010. The forecast contraction in global economic activity in 2009 is attributed more to weaker performance in advanced economies and the concomitant contraction in trade flows (Chart 8). It is expected that the stimulus packages and financial support to the financial system and other industries, as well as enhanced bilateral and multilateral support for vulnerable economies, would contribute to a quicker economic recovery. It is, however, projected that growth will remain significantly lower than long-term potential. In the circumstances, global inflation remains low and is forecast to average 2.5 percent for 2009. However, there is an upside risk to the inflation outlook due mainly to uncertainties with respect to developments in international oil prices (around USD70 in July from a low of USD44 in December 2008).

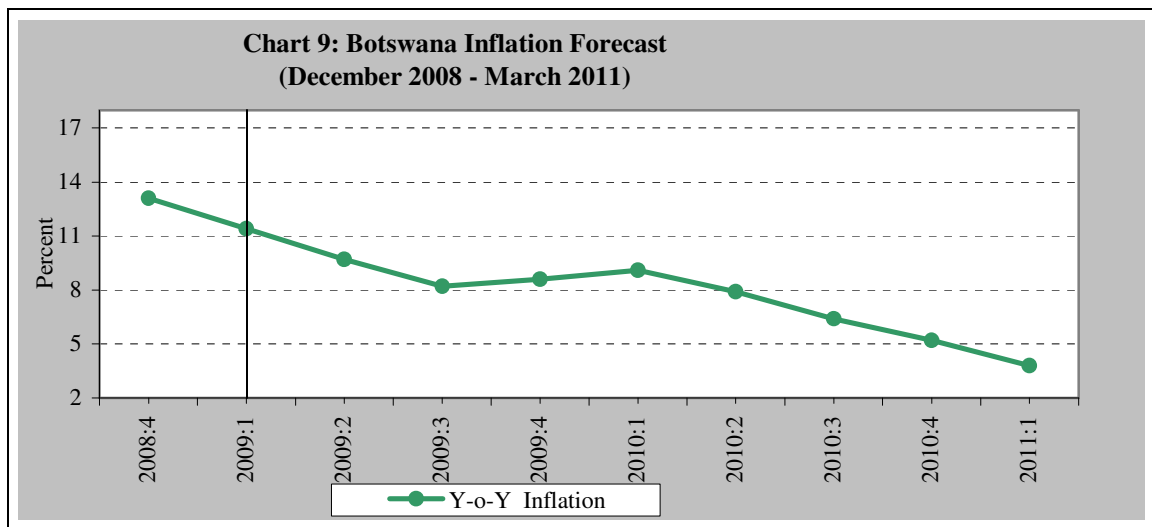


Note: 1. Developed economies include USA, UK, Euro area, Japan, Norway, Canada, Australia, Sweden, New Zealand and Switzerland
 2. Data for 2008Q1 – 2009Q1 are estimates, while those for 2009Q2– 2009Q4 are projections
 Source: JP Morgan

- 5.4 The domestic economy, which contracted in the last quarter of 2008 and the first quarter of 2009, is projected to have recovered to positive growth in the second quarter, largely reflecting developments in the world economy and the consequent beneficial impact on the diamond sector; this trend is expected to be sustained going forward. However, it is expected that output will remain below the long-term trend, with the resultant negative output gap signifying low demand pressures on inflation over the medium term. The March 2009 Business Expectations Survey (BES) revealed widespread pessimism among both the domestic and export-oriented firms. Overall, business confidence had declined from 82 percent in the September 2008 survey to 40 percent in the March 2009 survey. Businesses, nevertheless, anticipated positive output growth in 2009/10, possibly buoyed by government efforts to maintain spending at levels sufficient to support growth outside the mining sector. While the government will incur a large budget deficit to support

economic activity, expenditure growth will be at a lower level given the ongoing project review. It is also anticipated that expansion of credit to the private sector will continue to slow in the context of lower growth in economic activity, more cautious lending approach by banks and restrained demand for credit, as well as a moderate increase in personal incomes. In this regard, the March BES indicated much reduced expectations of additional borrowing, from both domestic and external sources.

- 5.5 The narrowing inflation differentials between Botswana and the trading partner countries suggest continuance of a marginal downward rate of crawl with virtually no upward pressure on inflation. However, market forecasts suggest that the rand will appreciate in the short-term and the resultant depreciation of the Pula against the South African rand will exert some modest upward pressure on domestic inflation. Additional upside risks to the inflation outlook include possible large increases in administered prices, notably an increase in electricity tariffs in the context of higher power import costs and to recover the costs of expansion of generation and supply infrastructure. Meanwhile, the March 2009 BES shows expectations of a decline in inflation, with businesses anticipating lower rates of increase for business costs, including raw materials and wages. Overall, the Bank forecasts that inflation will, in the short to medium-term, stabilise around the objective range (Chart 9).

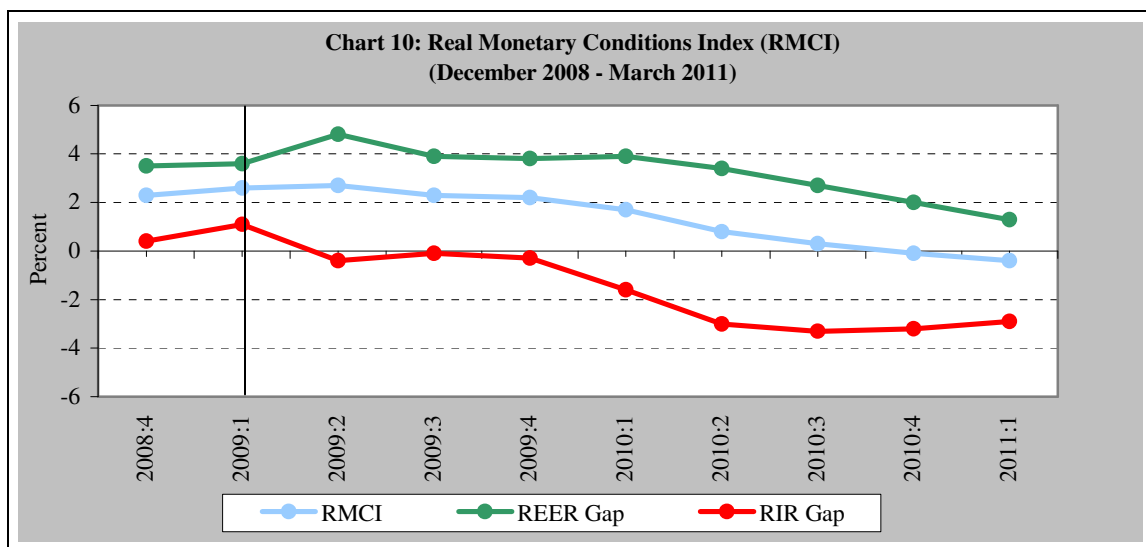


6. Monetary Policy Stance

- 6.1 The recent and prospective economic developments indicate a continuation of sluggish economic growth, due to lower external demand, a reduced rate of government expenditure growth and a slower rate of monetary expansion. While it is anticipated that output expansion will resume following negative growth in the last quarter of 2008 and first quarter of 2009, in Botswana and globally, it is forecast that the ensuing rate of increase in output will be lower than the long-term trend. In turn, both the external and domestic demand pressures on inflation will continue to be low. In addition, there are base effects of the large impact of last year's 30 percent alcohol levy dropping out of the inflation calculation; hence the forecast for a further decline in inflation. On the other hand, the projected decrease in inflation provides scope for maintenance of expansionary

monetary policy to support domestic economic recovery, particularly in an environment in which fiscal stimulus is constrained by the fall in government revenues.

- 6.2 However, there are significant threats to the positive inflation outlook, notably the threat of an increase in fuel prices which has potential for wide-ranging second-round effects. In addition, the Botswana Power Corporation faces an increase in costs after the main supplier, ESKOM, was given permission to raise tariffs. Furthermore, in order to help finance expansion of the power supply infrastructure, there could be a large and inflationary increase in local electricity tariffs. In addition, there remains a possibility of an upward adjustment of other administered prices and consumption taxes, as well as government levies, particularly given the strain on fiscal resources. However, such one-off price developments would be transitory and, to the extent that the second-round impact and expectations are contained, would not result in a continuous rise in inflation.
- 6.3 Overall, output projections and prospects for monetary expansion indicate benign upward pressures on inflation. Except for a sustained increase in fuel prices, the effect of changes in other administered prices and taxes would be transitory. The important thing, however, is taking appropriate and timely action to contain second-round effects and to manage expectations. As reflected in Chart 10, going forward, the projected movements in real exchange rates and real interest rates, as well as narrowing inflation differentials vis-à-vis trading partner countries suggest less tight monetary conditions.¹²



7. Summary and Conclusions

- 7.1 Inflation eased in the first six months of 2009, thus continuing a trend that started in the last half of last year, mainly influenced by the decrease in fuel prices and in the context of low domestic demand pressures, as well as a benign external inflationary environment.

¹² The assessment of real monetary conditions measures the relative easiness or tightness of monetary policy and gauges the effect that monetary policy has on the economy through changes in the exchange rate and interest rates. The real monetary conditions are measured by an index (RMCI) that combines, through a weighted average, the deviations of the real exchange rate and real interest rate from their trend values.

While inflation remained above the Bank's medium-term objective range of 3 – 6 percent in the period under review, the medium-term outlook of low inflation enabled the Bank to ease monetary policy, reducing the Bank Rate by 400 basis points between December 2008 and June 2009.

- 7.2 *It is anticipated that external inflationary pressures will continue to be restrained due to weak demand and slack labour market conditions (hence, low wage pressures) and stabilisation of commodity prices at lower levels than in the previous year. Weaker domestic economic activity, a lower rate of increase in business costs and restrained growth in personal incomes will also moderate demand pressures on inflation. There remain upside risks to inflation due to uncertainty on international oil price movements and a possible large increase in administered prices. Overall, it is expected that inflation will stabilise around the medium term objective range in the short to medium term.*
- 7.3 *In the circumstances, the prevailing monetary policy stance that is characterised by a monetary easing bias remains appropriate in the short term and supports a recovery of economic activity, including maintenance of robust performance of the non-mining sectors. The Bank will continue to monitor economic and financial developments with a view to responding appropriately to ensure medium term price stability without jeopardising the anticipated economic recovery and growth.*